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Volume Author/Editor: Paul F. Smith

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CHAPTER 5

Federal Credit Unions

CREDIT unions differ from the other institutions covered in this study because they are consumer cooperatives with the dual objective of encouraging savings and providing credit for their members. Their lending operations are restricted to their membership, which is typically limited to definable groups with some common affiliation, such as the employees of a business concern, government agency, or the members of a church or fraternal group.

The cooperative nature of credit unions plays an important role in determining the level of their gross finance charges. Their operations are subsidized in part by the voluntary work of their members and by direct or indirect assistance from sponsoring organizations. They obtain most of their funds from their membership in the form of savings and do not have to provide the return required for risk capital obtained from equity markets. As cooperatives, they are exempt from income taxes levied on other financial institutions.

Federal credit unions operate under federal charters and supervision, which prescribe in considerable detail the nature of their operations and requires annual examinations by federal authorities. Maximum charges on loans are set at 1 per cent a month on the unpaid balance and the maximum maturity is five years. Unsecured loans are limited in size to $750 and the maximum loan of any kind is limited to 10 per cent of the organization's paid-in capital and surplus. Other sections of the law specify the organization of individual credit unions and outline many of the details of their operations.

Individual credit unions are similar in many respects because of the centralized control and supervision, but they differ widely in size and administration. They vary from the small credit union with a few thousand dollars in assets, part-time management, and no regular hours or office space to the multimillion dollar credit union with professional management and full-time operations.

The information used in this study is based on compilations prepared for all federal credit unions by the Bureau of Federal Credit Unions. Financial ratios were computed from aggregate data and are, therefore, weighted by the dollar amounts at individual credit unions rather than by a unit weight for each company as in other parts of the study. The distribution of federal credit unions by asset size as shown in Table 22 indicates the relative importance of different size groups in the total.

TABLE 22

NUMBER AND DISTRIBUTION OF FEDERAL CREDIT UNIONS
BY ASSET SIZE, END OF 1959

Asset Size (dollars)	Number	Total Assets: Thousand Dollars	Total Assets: Per Cent
Total	9,447	2,352,813	100.0
Under 5,000	637	1,563	.1
5,000 to 9,999	563	4,146	.2
10,000 to 24,999	1,188	20,222	.9
25,000 to 49,999	1,342	49,212	2.1
50,000 to 99,999	1,506	108,843	4.6
100,000 to 249,999	1,989	321,760	13.7
250,000 to 499,999	1,084	385,087	16.4
500,000 to 999,999	653	448,747	19.0
1,000,000 to 1,999,999	337	456,615	19.4
2,000,000 to 4,999,999	122	348,701	14.8
5,000,000 and over	26	207,917	8.8

Source: 1959 Report of Operations, Federal Credit Unions, U.S. Department of Health, Education, and Welfare, Table 14, p. 20.

Appendix A contains a detailed description of the processing of the federal credit union data used in this study.

Uses of Funds

Federal credit unions are limited in their use of funds to loans to their members or to other credit unions, investments in U. S. government securities, and deposits in banks or savings and loan associations. At the end of 1959, 70 per cent of their assets were in loans to members (Table 23). They make personal cash loans for purchases of household goods, consolidation of debt, payment of insurance, hospital, or medical expenses, or any other personal needs. Most of their loans are small, except those for the purchase of automobiles which accounted for 30 per cent of the dollar amount and 13 per cent of the number of loans made in 1956.[1] Their automobile loans are similar in nature to other cash loans except that they are usually larger in amount and are secured by

[1] *1956 Report of Operations, Federal Credit Unions,* U. S. Department of Health, Education, and Welfare, p. 12.

TABLE 23

USES OF FUNDS BY FEDERAL CREDIT UNIONS, END OF 1959
(per cent)

Item	All Asset Sizes	Asset Size (dollars) 1,000,000 and Over	50,000 to 999,999	Under 50,000
Earning assets	93.1	94.0	92.8	86.1
Consumer loans	70.8	68.3	72.6	75.3
Other	22.3	25.7	20.2	10.8
Cash and bank balances	5.9	4.6	6.4	13.1
Other assets	1.0	1.4	.8	.8
Total	100.0	100.0	100.0	100.0

Source: Based on data published by the Bureau of Federal Credit Unions.

the automobile. They frequently carry the same finance charges as other loans.

Since credit unions can only make loans to members, they frequently have more funds than they need to satisfy the loan demand. Excess funds may be invested in government securities or in savings and loan shares. Investments of this type accounted for 22 per cent of the total assets of all federal credit unions in 1959.

The availability of funds for investment in assets other than loans varies greatly at different credit unions. Some have a loan demand in excess of the savings they attract; others have to limit the saving they accept or invest a sizable proportion of their funds at low yields. The older and larger credit unions usually have a larger share of their funds in government securities or saving and loan shares than the newer organizations. Larger credit unions—those with assets of more than $1 million—had 26 per cent of their assets in such investments in 1959 while those with assets of less than $50,000 had only 11 per cent in non-consumer investments (Table 23). A similar difference appears between the portfolios of well-established and new credit unions. Credit unions in existence twenty-five years carried ten times as much of their assets in government securities and savings and loan shares as those in existence less than a year.[2]

[2] *1959 Report of Operations, Federal Credit Unions,* p. 13.

Every credit union must hold some of its funds in cash and demand accounts to meet its operating needs. Since they are not subject to reserve requirements or to demands from creditors for compensating balances, the amount of cash they hold depends upon their operating needs and the alertness of their managers in converting idle balances into earning assets. The ratio of cash balances to total assets declines with the age and size of the credit union. New credit unions hold a considerably larger share of their assets in cash and bank balances, while older ones, either because of experience or more predictable liquidity requirements, invest a larger share of their funds. The larger credit unions held less than 5 per cent of assets in cash, while the small ones averaged 13 per cent.

Finance Charges

Finance charges at federal credit unions average $10.04 per $100 of outstanding loans for 1959. The actual cost of credit to consumers was somewhat smaller, however, because life insurance is often covered by the charge and partial interest refunds may be made. Interest refunds were first authorized in 1954 by an amendment to the Federal Credit Union Act. After the cost of credit life insurance and the value of refunds is deducted, the adjusted finance charge averaged $9.13 per $100 of loans in 1959.

Finance charges of individual credit unions varied as did practices with respect to interest refunds and free life insurance. The average adjusted finance charge was slightly less than 9 per cent at the credit unions with more than $1 million in assets and somewhat more than 9 per cent at the smaller credit unions; 17 per cent of all federal credit unions refunded some interest, while 89 per cent provided borrowers' life insurance.[3] Interest refunds were larger at the million-dollar credit unions, but a larger proportion of the small organizations refunded interest.

Finance charges at credit unions have not changed greatly in the past two decades. They averaged $10.88 per $100 of outstanding credit in 1939, as opposed to $10.04 per $100 in 1959. The net cost to consumers has probably declined, however, with the growth of interest refunds and free insurance. Separate data are not available in earlier years to adjust gross figures to obtain estimates of the actual finance charge, but before World War II interest refunds were not permitted and credit life insur-

[3] *Ibid.*, p. 10.

ance was less commonly used. The adjusted finance charge in 1959 of $9.13 per $100 of loans was 16 per cent below the unadjusted finance charge in 1939. A substantial part of this difference represents a decline in average cost of credit to the consumer.

Components of Finance Charges

Credit union operations involve most of the costs incurred by private lenders. The difference lies primarily in the extent of free services available to credit unions from their membership or sponsors. They incur costs in extending credit, maintaining records, and collecting loans. In addition, they must pay for the funds used in making loans. Since most of their funds come from their members, they must pay enough in the form of cash dividends or service to attract the savings of their members.

Credit unions are difficult to compare with stockholder-owned institutions because the shareholders play a dual role of depositor and stockholder. The cash dividends paid to shareholders are similar to the dividends paid to stockholders, while funds retained in the credit union increase the shareholder's net worth just as in a stockholder-owned company. The shareholders in a credit union may receive free life insurance in addition to many of the benefits of the depositors of a bank or savings institution. In a private institution the cost of handling deposits is a cost of obtaining the nonequity funds. In a credit union the depositors (shareholders) and owners are the same people and the funds they provide could be regarded as nonequity or equity funds. Similarly, the payments to shareholders and the costs of handling their accounts could be regarded as either a cost of nonequity or equity funds. If they were treated as a cost of nonequity funds, they would be deducted in arriving at net income. For purposes of this study, the costs of handling share accounts were treated as a service rendered to the shareholders and considered part of the cost of equity funds.[4] The cost of handling shares had to be estimated, as no separate cost data were available. These estimates were necessarily rather crude but they indicate the approximate magnitude of an essential element in the cost of credit union operations. The estimates were based on the analogous operations of banks with respect to time deposits with allowances for the lower operating costs of credit unions.

The return on equity funds represents the largest component of the finance charge at credit unions and in 1959 accounted for 63 per cent

[4] For a similar treatment of payments to shareholders as a cost of equity, see John T. Croteau, *The Federal Credit Unions,* New York, 1956, p. 91.

of adjusted charges (Table 24). Operating expenses, including salaries and wages, rent, supplies, and losses on loans, accounted for 36 per cent and the cost of borrowed funds for only 1 per cent of the total.

No clear trend in the major components of credit union costs is evident from the data for 1949–59. Year-to-year fluctuations were larger than the changes that took place over the period covered by the study.

Operating Expenses

The operating expenses of credit unions are not fully covered by the dollar costs reported in their accounting statements. A substantial share of their costs is absorbed by voluntary services from members or by the provision of office space or other assistance by sponsoring organizations, and no estimate is possible of the dollar value of these contributions. A rough indication of the costs of providing similar services under less advantageous conditions can be obtained, however, by comparing their

TABLE 24

COMPONENTS OF FINANCE CHARGES ON CONSUMER CREDIT AT FEDERAL CREDIT UNIONS, 1959
(per $100 of average outstanding credit)

Item	Distribution	
	Dollars	Per Cent
Adjusted finance charges (lender's gross revenue)[a]	9.13	100.0
Operating expenses	3.30	36.1
Salaries	1.77	19.3
Occupancy costs	.06	.6
Advertising	.07	.8
Losses charged off	.38	4.2
Other	1.02	11.2
Nonoperating expenses	5.83	63.9
Cost of nonequity	.12	1.3
Cost of equity funds	5.71	62.6
Retained	.98	10.7
Service to shareholders[b]	.73	8.0
Dividends	4.00	43.9

Source: Based on data published by the Bureau of Federal Credit Unions.

[a] Includes all finance charges and fees collected on loans. The cost of free insurance provided borrowers and interest refunds were deducted.

[b] Includes cost of free life insurance for shareholders and cost of handling share accounts.

operating expenses with those of consumer finance companies. The operating expenses of the nine-company sample of consumer finance companies averaged $14.25 per $100 of outstanding loans in 1959, compared with $3.30 per $100 reported by the federal credit unions.

Most of the operating expenses of credit unions are similar to those of other credit grantors. Loans must be screened and investigated; records must be maintained; payments must be made and loans collected. The size and value of many of these costs are very different for a cooperative organization with a limited field of membership than for a stockholder-owned organization operating with the public. Credit investigations and collections are handled in different ways and advertising and promotion expenses are much less important.

Salaries comprise the largest item of credit union operating expenses and averaged 54 per cent of the total in 1959 (Table 24). League dues and supervisory fees accounted for 9 per cent of total operating expenses, while rent and other occupancy costs amounted to only 2 per cent.

The pattern of expenses varied widely with the size of the credit union. Salary costs tend to increase with the size of the organization; they accounted for 63 per cent of the adjusted expenses of credit unions with assets of at least $1 million, but only 46 per cent of the expenses of those with assets of less than $50,000 in 1959.[5] As credit unions grow and expand in size, voluntary help becomes inadequate to meet operating needs and more full-time and professional help is needed.

Despite the growth in salary cost with the size of operations, total expenses in relation to income tend to decline with the age of the organization. Data published by the Bureau of Federal Credit Unions show considerably higher ratios of expenses to income for credit unions in operation eight years or less than for those in operation twenty years or more.[6] This suggests that rising age implies a growth in managerial experience and efficiency which, when combined with the advantages of size, more than offsets the increase in salary costs associated with increasing size.

Total operating expenses per $100 of outstanding loans declined slightly from 1949 to 1959, which reflected a drop in average salary expenditures per $100 of loans. All other cost items were slightly higher. Available data are not adequate to explain fully the decline in salary expenses. The growth in the average size of loan from $260 in 1949 to

[5] *1959 Report of Operations, Federal Credit Unions,* p. 25. Published figures for total expenses were adjusted to exclude interest on borrowed money and expenses of borrowers' and life savings insurance.

[6] *Ibid.,* p. 14.

$593 in 1959 undoubtedly helped reduce the costs per dollar. The increased efficiency and management experience that accompany the aging of credit unions may also have played a part. The share of average salary cost in operating expenses at all federal credit unions between 1949 and 1959 dropped from 60 to 54 per cent.

Losses charged off in any year depend in part upon economic conditions, so that trends are difficult to detect over such a short period. Loan losses per $100 of loans were higher on an average in the last half of the 1950's than in the first half, although the highest loss rate was recorded in the postrecession year of 1954.

Sources of Funds

Federal credit unions depend mostly upon the savings of their members for their loanable funds. Almost 90 per cent of their resources were derived from shares of members at the end of 1959. The proportion varied somewhat with the size and age of the credit union, and was higher at the older and larger credit unions than at the younger and smaller organizations (Table 25).

TABLE 25

SOURCES OF FUNDS FOR FEDERAL CREDIT UNIONS, END OF 1959
(per cent)

Item	All Asset Sizes	Asset Size (dollars)		
		1,000,000 and Over	50,000 to 999,999	Under 50,000
Debt	2.5	1.8	3.0	4.0
Other liabilities	0.5	0.7	0.3	0.3
Total nonequity funds	3.0	2.5	3.3	4.3
Shares	88.2	88.7	87.8	87.9
Reserves and undivided earnings	8.8	8.8	8.9	7.8
Total equity funds	97.0	97.5	96.7	95.7
Total	100.0	100.0	100.0	100.0

Source: Based on data published by the Bureau of Federal Credit Unions.

Borrowing plays a minor role in most credit union operations. Smaller credit unions—those with assets of less than $50,000—obtained 4 per cent of their total resources by borrowing in 1959. The average for all credit unions was only 2.5 per cent. Many of them are faced with the problem of finding outlets for surplus funds rather than with a shortage of funds.

Reserves and undistributed earnings provided an average of 9 per cent of the total credit unions' funds in 1959. Most of this amount was in reserves of various types. The Federal Credit Union Law requires that 20 per cent of earnings must be set aside for a regular reserve until the amount of the reserves reaches 10 per cent of shares. In addition, it requires that a special reserve be established to cover questionable loans when the regular reserve has not reached full size. The size of the special reserve is determined by the amount and the age of delinquent loans.

Nonoperating Expenses

The nonoperating costs of federal credit unions averaged $5.83 per $100 of outstanding loans, or 64 per cent of the adjusted finance charge in 1959 (Table 24). Since credit unions do not pay income taxes and use relatively small amounts of nonequity funds, nearly all of this amount represents the cost of equity funds. Half of the finance charge was paid to shareholders either in cash dividends or services of various types; 10 per cent was retained in reserves and undistributed earnings.

Nonequity funds play such a small role in credit union operations that the costs of these funds represented about 1 per cent of the finance charge, or 12 cents per $100 of outstanding loans. Although the rate paid for borrowed funds by federal credit unions has increased since 1949, the increase has been smaller than the rise in market rates in general. The cost of interest on borrowed funds as a percentage of total nonequity funds rose from 2.4 to 3.8 per cent. Credit unions were able to offset the increase in the cost of funds by more efficient use of their resources. The percentage of total assets held in cash, bank balances, and other nonearning forms declined from 11 to 8 per cent during the same period. The net cost of nonequity funds used in their lending operations accordingly changed very little.

Net Income

All borrowers from credit unions must also be shareholders. In practice, however, the membership of a credit union can be divided into two fairly distinct groups: those who are predominantly savers and those who are predominantly borrowers. The dual objective of the credit union movement requires that both groups be considered in management decisions. Each credit union, however, has considerable flexibility within the range of market competition to adjust the flow of funds between the borrower and saver groups. Earnings can be distributed in dividends to shareholders or, since 1954, as interest refunds to borrowers. The rates on loans may be adjusted, within legal limits, to increase or decrease the earnings available for dividends. The dividends paid on shares together with the services available to the shareholders must be large enough to attract and hold funds in the organization and the rate on loans must be low enough to meet competition. Within these limits, however, the management can pursue a variety of policies and objectives designed to accommodate both borrowers and savers.

As a result of the dual objective of credit union management, the attempt to maximize the return on equity funds probably does not play as important a role in credit union decisions as in those of stockholder-owned companies. The demands of the credit union shareholders must be met, however, because they provide the bulk of the funds and in many cases dominate the management. Cash dividends and services must be enough to attract and hold their savings, and the total return must be large enough to build the required reserves.

The return on equity funds (net income to equity funds) at credit unions averaged about 5 per cent from 1949 to 1959, including the cost of handling share accounts and the cost of life insurance for shareholders (Table 28). Cash dividends in 1959 were only 3.4 per cent of equity and fell below 3 per cent in a number of years. This relatively low return on equity compared with net earnings of between 5 and 6 per cent on consumer lending activities reflects the low yield on nonconsumer investments, the cost of nonearning assets, and the minor importance of the use of borrowed funds.

RETURN ON OTHER EARNING ASSETS

The return from other earning assets of credit unions reduces the effective return on their consumer credit. Since they are only permitted to invest in government securities, savings and loan shares, or loans to other credit unions, the yield on the other earning assets is low. In 1959 these earnings were 3.8 per cent of invested funds, compared with 9.1 per cent on consumer loans (Table 26).

The return on nonconsumer investments improved slightly during the period with the rise in interest rates. Credit unions earned an average

TABLE 26

SELECTED EARNING RATIOS FOR FEDERAL CREDIT UNIONS, 1949-59
(per cent)

Year	Ratio of Earnings to Invested Funds: Consumer Loans	Ratio of Earnings to Invested Funds: Other Earning Assets	Ratio of Net Operating Income to Invested Funds: Consumer Loans	Ratio of Net Operating Income to Invested Funds: All Earning Assets	Ratio of Net Operating Income to Invested Funds: Total Assets
1949	9.4	2.9	5.9	4.8	4.3
1950	9.7	2.9	6.5	5.4	4.8
1951	9.6	2.7	6.1	5.1	4.5
1952	9.5	3.0	6.1	5.2	4.6
1953	9.7	3.1	6.4	5.5	4.9
1954	9.6	3.1	6.0	5.3	4.7
1955	9.6	3.1	6.6	5.7	5.1
1956	9.5	3.2	6.3	5.5	5.0
1957	9.3	3.5	6.1	5.5	4.9
1958	9.2	3.5	5.9	5.3	4.8
1959	9.1	3.8	5.8	5.3	4.9

Source: Based on data published by the Bureau of Federal Credit Unions.

of 3.8 per cent on their nonconsumer assets in 1959, compared with 2.9 per cent in 1949. This was still well below the net operating income that they made on consumer assets, however.

Nonearning assets reduced the return on total funds employed so that credit unions averaged 4.9 per cent on their total assets, compared with a return of 5.3 per cent on their invested funds in 1959. Over the eleven years studied, credit unions reduced the proportion of assets held in nonearning forms and narrowed the spread between the rate earned on invested funds and that earned on all funds.

RETURN FROM NONEQUITY FUNDS

Borrowed funds add relatively little to the return of credit unions because the amounts involved are so small. Since credit unions only obtain, on an average, 2–3 per cent of their funds from nonequity sources, the financial advantage or leverage obtained from these funds is not very important to the net income of credit unions. Table 27 shows the contribution of nonequity funds to the return of net worth of credit unions, which is only a fraction of a percentage point. Credit unions have very little of the financial advantage of using borrowed funds that is so important in the operations of stockholder-owned institutions. The rate

TABLE 27

RETURN FROM USE OF NONEQUITY FUNDS AT FEDERAL CREDIT UNIONS, 1949-59
(per cent)

Year	Ratio of Net Operating Income to Total Assets (1)	Ratio of Cost of Nonequity Funds to Nonequity Funds (2)	Ratio of Net Return on Nonequity Funds to Nonequity Funds[a] (3)	Ratio of Nonequity Funds to Equity (4)	Ratio of Net Return from Nonequity Funds to Equity Funds[b] (5)
1949	4.3	2.2	2.1	.0295	.06
1950	4.8	2.9	1.9	.0342	.06
1951	4.5	2.8	1.7	.0273	.04
1952	4.6	2.9	1.7	.0243	.04
1953	4.9	3.1	1.8	.0282	.05
1954	4.7	3.0	1.7	.0251	.04
1955	5.1	3.2	1.9	.0246	.05
1956	5.0	3.2	1.8	.0263	.05
1957	5.0	3.6	1.4	.0264	.04
1958	4.8	3.3	1.6	.0244	.04
1959	4.9	3.1	1.8	.0269	.05

Source: Based on data published by the Bureau of Federal Credit Unions.

[a] Column 1 minus column 2.

[b] Column 3 times column 4.

earned by credit unions on their assets is very close to the rate they earn on net worth.

Disposition of Net Income

The net income of credit unions, which is the counterpart of net profits at the other type of institution, ranged between 4.3 and 5.2 per cent of total assets during the eleven years covered by the study (Table 28). The return fluctuated from year to year with no distinct trend. The proportion of net income paid in cash dividends increased from 63 per cent in 1949 to nearly 70 per cent in 1959.

The net income figures used in this study include the costs of services rendered to the shareholders—the cost of handling share accounts and the cost of life insurance. The value of these services increased slightly during the 1950's, and in 1959 they accounted for 14 per cent of net income.

The value of combined benefits to shareholders accounted for 83 per cent of net income in 1959, compared to 75 per cent in 1949. The

TABLE 28

NET INCOME AND DIVIDENDS AT FEDERAL CREDIT UNIONS, 1949-59
(per cent)

Year	Net Income as Percentage of Equity Funds	Disposition of Net Income: Total	Retained	Services to Shareholders[a]	Dividends	Dividends as Percentage of Shares
1949	4.3	100.0	24.8	12.4	62.8	2.9
1950	4.9	100.0	29.4	10.6	60.0	3.1
1951	4.6	100.0	24.0	13.4	62.6	3.1
1952	4.6	100.0	23.0	13.5	63.5	3.2
1953	5.0	100.0	26.1	12.5	61.4	3.3
1954	4.8	100.0	22.3	13.1	64.5	3.4
1955	5.2	100.0	22.7	12.3	61.0	3.4
1956	5.1	100.0	22.3	12.8	64.9	3.6
1957	5.1	100.0	20.9	13.0	66.1	3.7
1958	4.9	100.0	16.8	14.0	69.2	3.7
1959	5.0	100.0	16.9	13.9	69.2	3.8

Source: Based on data published by the Bureau of Federal Credit Unions.

[a]Includes cost of life insurance for shareholders and estimate of cost of handling share accounts.

increase in importance of dividends and other direct benefits resulted in a drop in the proportion of net income retained in reserves and undistributed earnings. This decline probably reflects in large part the attainment of the level of reserves specified by the Federal Credit Union Law by many of the credit unions. After the required level is reached, a share of net income no longer has to be allocated to reserves, and a larger proportion can be devoted to dividends. There is very little incentive for most credit unions to retain earnings because they frequently have to place any excess funds in low-yielding investments that reduce the average return on assets.

Dividend payments in 1959 amounted to 3.8 per cent of the value of average outstanding shares, which compares with a rate of 2.9 per cent in 1949 and follows the general rise in savings rates that took place during that period at all savings institutions. Actual dividend payments differ widely at individual credit unions. About 6 per cent of the federal credit unions paid 6 per cent on their shares in 1959, while 3 per cent paid less than 3 per cent. The median rate was 4.4 per cent.[7]

[7] *Ibid.*, p. 7.